Adjusting to change

The Basel III credit value adjustment charge could mean banks have to apply a capital charge on some sovereign-related clients for the first time. A reluctance by these clients to post collateral means these costs could be large. By ***Laurie Carver***

Regulators are slowly fine-tuning their approach to the posting of collateral on uncleared swaps. Five US prudential regulators published their proposals on the subject in April, which set out detailed requirements for the calculation, posting and segregation of margin on non-cleared derivatives. The US government is exempt, but foreign sovereigns will be captured by the rules if they trade with a US dealer – creating the possibility that sovereign entities will have to post collateral, in the majority of cases for the first time.

Many are not happy about it, claiming they will shun US dealers as a result (*Risk* June 2011, page 9, *www.risk.net/2074089*). That's because many sovereign, supranational and agency (SSA) clients have not historically been required to post collateral on their derivatives trades, instead operating under so-called one-way credit support annexes (CSAs) – agreements that oblige the dealer to post margin, but don't require the sovereign to reciprocate.

There have been a few exceptions. *Risk* reported last year that Portugal had decided to sign two-way CSAs with its derivatives counterparties (*www.risk.net/1724576*), and a handful of other SSA clients have followed suit (*Risk* February 2011, page 8, *www.risk.net/2023483*). The majority, however, are keen to stick with the status quo.

This stance poses some problems for dealers, though. Most notably, one-way CSAs create massive funding exposures worth tens of billions of dollars across the major dealers. That arises from the fact that banks tend to hedge their positions with other dealers, which are typically covered by two-way CSAs. So, when the market value of a trade is positive for the dealer, the sovereign would not be required to post margin. However, the hedge would have a negative value for the bank, requiring it to pass collateral to its counterparty, resulting in a potentially significant funding cost.

Research conducted by *Risk* earlier this year put the funding exposure at $29.3 billion for five contributing dealers, with the industry-wide estimate reaching as high as $150 billion (*Risk* February 2011, pages 19–22, *www.risk.net/2029544*).

But there are other implications arising from the refusal by SSA clients to post collateral. Crucially, banks will be required to comply with the credit value adjustment (CVA) capital charge under Basel III from 2013. This will mean banks will have to hold capital against sovereigns, in some cases for the first time – and these figures could be sizeable. It could ultimately increase costs for SSA clients, and eventually end up pushing them to adopt two-way CSAs, some participants predict.

The Basel Committee on Banking Supervision lays out two approaches for the calculation of a CVA capital charge – a standardised and an advanced model. The former involves applying risk weights to counterparties, based on ratings. The advanced approach is also quite prescriptive in specifying a functional form for the charge, leaving only the spread dynamics open to modelling. The formula is far more sensitive to the volatility of the spread than the actual credit default swap (CDS) level, and weights the changes in an exponential function of the spread by the expected exposure. This means an uncollateralised trade would attract a far higher capital charge than one backed by margin.

The capital charges will be particularly noticeable for sovereign counterparty exposures as a result, say dealers. In fact, it may actually discourage some banks from using the more advanced models for sovereign clients, as they may prefer to calculate

Manoj Bhaskar, HSBC